

General Information Letter: Response to survey on IRC Section 529 plan taxation.

September 9, 2002

Dear:

This is in response to your letter dated July 20, 2001 in which you request that the Illinois Department of Revenue provide responses to your survey questions. The following are our responses to your 2001 Survey:

SURVEY I-IV UPDATE OF 2001

1. Is the 2001 survey information on Illinois still correct for 2002?

Answer: Yes

2. Have any legislative and/or regulatory changes relevant to the survey, occurred since we contacted you last year?

Answer: No.

3. Are copies of the relevant changes attached?

Answer: N/A

4. Please describe any change(s) that should be made to the survey results.

Answer: N/A

SURVEY V – SECTION 529 PLANS

1. For the 2002 tax year, does Illinois provide favorable tax treatment (such as a tax deduction) for contributions to 529 Plans? If yes, please explain the favorable treatment and any limit (such as per beneficiary, contributor or account) on the amount of contributions eligible for such treatment.

See Below

2. For the 2002 tax year, does Illinois tax rollovers of contributions and appreciation from one 529 plan account to another? If yes, please explain.

See Below

3. For the 2002 tax year, does Illinois tax distributions from 529 plan accounts used to pay qualified higher education expenses (i.e. the distributions are tax-free for federal tax purposes)?

See Below

4. For the 2002 tax year, does Illinois impose tax or penalties (in addition to income tax on earnings) on distributions from 529 plan accounts used to pay non-qualified higher education expenses (i.e., where the distributions are not tax free for federal tax purposes)?

See Below

Illinois taxation of Section 529 plans

Section 16.5 of the State Treasurer Act, 15 ILCS 505/16.5, provides that the State Treasurer may establish and maintain a College Savings Pool in order to provide investment opportunities to persons seeking to finance the costs of higher education. The State Treasurer has titled the College Savings Pool program "Bright Start." Section 16.5 also states that the assets and income of a Bright Start program shall be exempt from all taxation by the State of Illinois. Section 15 of the Illinois Prepaid Tuition Act, 110 ILCS 979/15, creates the Illinois Prepaid Tuition program to better enable Illinois families to finance the costs of higher education. Section 55 of the Illinois Prepaid Tuition Act states that the assets and income of the Illinois Prepaid Tuition Trust Fund shall be exempt from all taxation by the State of Illinois.

Section 529(a) of the IRC states that a qualified state tuition program shall be exempt from federal income tax, except for the taxes imposed under IRC Section 511 (relating to the tax on unrelated business taxable income).

Under the Illinois Income Tax Act ("IITA"; 35 ILCS 5/101 *et seq.*), a taxpayer's Illinois base income is generally equal to its federal taxable income, adjusted by certain statutorily prescribed addition and subtraction modifications (See IITA §203). IITA Section 203(e)(1) defines "federal taxable income" for this purpose as the taxpayer's *"taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code."*

A Section 529 plan that is exempt from federal income tax does not have federal taxable income as defined under IITA section 203(e)(1). In addition, none of the statutorily prescribed addition modifications can apply. Accordingly, a Section 529 plan exempt from federal income tax does not have any Illinois base income and thus does not incur an Illinois income tax.

Illinois taxation of Section 529 plan participants and beneficiaries

An individual's Illinois base income is equal to his or her federal adjusted gross income, modified by certain statutorily prescribed addition and subtraction amounts. As indicated above, Section 16.5 of the State Treasurer Act exempts the assets and income of a Bright Start program from all taxation by the State of Illinois. Section 55 of the Illinois Prepaid Tuition Act provides the same with respect to the Prepaid Tuition Trust Fund. In addition, Section 16.5 of the State Treasurer Act exempts from Illinois tax earnings accrued on investments in a Bright Start program upon distribution on behalf of a designated beneficiary to the extent used to pay qualified expenses. See Department Regulations §100.2470(g)(5). Likewise, Section 55 of the Illinois Prepaid Tuition Act exempts from tax the distribution of earnings accrued in the Prepaid Tuition Trust Fund to the extent used for educational purposes. See Department Regulations §100.2470(g)(4). Finally, IITA Section 203(a)(2)(Y) provides individuals a subtraction modification in the computation of base income for taxable years beginning

on or after January 1, 2002 in an amount equal to all moneys contributed during the taxable year to a Bright Start program.

Based on the above, Illinois' taxation of Section 529 plan participants and beneficiaries is as follows.

With respect to contributions, the subtraction modification provided under IITA Section 203(a)(2)(Y) applies only to contributions made to a Bright Start program. Therefore, contributions made to a Bright Start program are not subject to Illinois income tax. Contributions made to other Section 529 plans are not deductible.

With respect to accrued earnings within a Section 529 plan, the exemptions provided under Section 16.5 of the State Treasurer Act and Section 55 of the Illinois Prepaid Tuition Act apply only with respect to the earnings of a Bright Start program or Illinois Prepaid Tuition Trust Fund, respectively. Therefore, earnings accrued in a Bright Start program or Illinois Prepaid Tuition Trust Fund are not subject to Illinois income tax. See Department Regulations §100.2470(g)(4-5). The IITA does not contain an addition modification that applies to earnings accrued within other Section 529 plans. Consequently, earnings accrued within other Section 529 plans are subject to Illinois income tax only to the extent included in the taxpayer's federal adjusted gross income.

With respect to distributions, the exemptions provided under Section 16.5 of the State Treasurer Act and Section 55 of the Illinois Prepaid Tuition Act apply only to the distribution of accrued earnings from a Bright Start program or Illinois Prepaid Tuition Trust Fund, respectively. Therefore, distributions from a Bright Start program or Illinois Prepaid Tuition Trust Fund are not subject to Illinois income tax to the extent used to pay qualified expenses. The IITA does not contain an addition modification that applies to distributions from other Section 529 plans. Accordingly, distributions from other Section 529 plans are subject to Illinois income tax to the extent included in the taxpayer's federal adjusted gross income.

Additional Information

Public Act 92-0626 amended Section 16.5 of the State Treasurer Act, (15 ILCS 505/16.5) to provide an additional benefit to Bright Start program participants. Said Public Act states that contributions to a Bright Start Program are not considered in evaluating the financial situation of the beneficiary or deemed a financial resource for purposes of determining eligibility for scholarships, grants or monetary assistance awarded by the Illinois Student Assistance Commission, the State, or any agency thereof. In addition, contributions to a Bright Start do not reduce the amount of any scholarship, grant or monetary assistance the beneficiary is eligible to receive.

Said Public Act also creates an addition modification to a taxpayer's adjusted gross income for Illinois purposes for distributions from a Section 529 plan, other than distributions from a Bright Start program, for amounts excluded from gross income under Section 529(c)(3)(B) of the IRC.

Finally, said Public Act creates an exclusion from the subtraction modification for moneys contributed to a Bright Start program. Amounts excluded from gross income under Section 529(c)(3)(i) of the IRC are no longer considered moneys contributed for purposes of the subtraction modification to adjusted gross income.

I have enclosed a copy of P.A. 92-0626 for your file.

Person completing surveys:

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According to the Department of Revenue ("Department") regulations, the Department may issue only two types of letter rulings: Private Letter Rulings ("PLR") and General Information Letters ("GIL"). The regulations explaining these two types of rulings issued by the Department can be found in 2 Ill.Adm.Code §1200, or on our website <http://www.revenue.state.il.us/legalinformation/regs/part1200>.

Due to the nature of your inquiry, we are required to respond with a GIL. GILs are designed to provide information on specific topics. GILs, however, are not binding on the Department and does not constitute a statement of policy that either applies, interprets or prescribes tax law. It is not binding on the Department. Should you have additional questions, please do not hesitate to contact our office.

Sincerely,

Matthew S. Crain
Associate Counsel -- Income Tax